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By John Mauldin

"Another G-7 meeting has come and gone. And what has been accomplished? Next to nothing, in my view. The club of the world's wealthiest nations has punted on the big issues facing the global economy — namely, unprecedented current-account imbalances, currency misalignments, mounting trade tensions, and the liquidity-prone biases of central banks. The G-7's latest communiqué is emblematic of the increasingly vacuous rhetoric of globalization. This is a perilous course of inaction for a global economy beset with record imbalances." (Stephen Roach, Chief Economist, Morgan Stanley)

In his talks to Congress this week, Chairman Greenspan dropped in these words, which did not make the highlight reels, but nonetheless should be listened to: "People experiencing long periods of relative stability are prone to excess. We must thus remain vigilant against complacency."

The record imbalances which Roach alluded to are inherently unstable. They are the proverbial unsustainable trend. Yet things seem to be rocking along just fine. One of America's finest theoretical economists, Hyman Minsky, gave us this great quote, "Stability is unstable." What he meant by that is that the longer things remain the same, the more we expect them to remain the same and the more complacent we get. Thus, when things actually do change, the shock is much greater. Few have "remained vigilant." The long-term stability of trends is the seedbed for asset and credit bubbles of all types.

This week, we begin a multi-part series on that most unsustainable of all trends, the US trade balance. While the game can go on for much longer than reason would dictate, there will be an end to it. Will it be the soft landing with nations agreeing to work together to find a sort of Nash equilibrium; or, the hard landing where the "vacuous rhetoric of globalization" masks the reality of each nation going its own way, in a kind of "devil take the hindmost" world?

A Beautiful Equilibrium

In game theory, the **Nash equilibrium** (named after John Nash) is a kind of optimal strategy for games involving two or more players, whereby the players reach an outcome to mutual advantage. If there is a set of strategies for a game with the property

that no player can benefit by changing his strategy while (if) the other players keep their strategies unchanged, then that set of strategies and the corresponding payoffs constitute a Nash equilibrium. John Nash, the Nobel laureate in mathematics was featured in the movie "A Beautiful Mind." (Highly recommended, by the way.)

The US is living, many say, on the kindness of strangers. If it were not for the willingness of Chinese and Japanese central banks, along with their smaller Asian counterparts, to finance our trade deficit, we would be in perilous circumstances. If Asian currencies saw the dollar fall by 33%, they stand to lose over $600 billion in buying power due to their massive $1.8 trillion US dollar reserves. That is a massive amount of confidence.

Yet it works both ways. Exports to the US alone accounted for about 12% of China's GDP, and that was up from 9% in 2000. At current growth rates, US imports could be responsible for 20% of China's GDP by 2008. It may be that China is depending upon the kindness of strangers, in this case US consumers. Other Asian countries have similar, if not as dramatic, dependence upon US consumers. And many of them ship materials to China which eventually find their way to the US.

The elephant in the world economic room is the now $660 billion US current account deficit. At least $465 billion of that comes from foreign central banks. It is an odd Nash equilibrium. They take our paper, which they know will one day be worth less than it is today, in order to be able to sell us products which keeps factories growing. How long can the game continue? In the case of China, it may continue until the have established their own internal equilibrium of jobs for the hundreds of millions of peasants moving from the farms looking for a better life.

It is not a matter of things staying the same. There is in fact no Nash equilibrium into which the world has settled. We are still "playing the game" and some players may be opting to take advantage of others. The system itself is inherently unstable, as we will see. And if you have trouble understanding how the game is played, then take comfort in the fact that a US Senator, whose staff at least should know better, clearly does not understand the basics of how the economy works. I quote this from good friend Dennis Gartman:

"Secondly, we are now firmly convinced that Sen. 'Debbie' Stabenow (D-Michigan) is an utter and complete idiot. Why mince words, for clarity is what we are after here, and in her questioning of Mr. Greenspan yesterday Sen. Stabenow removed any and all possibilities that she is not an idiot. Taking a page from the manners of H. Ross Perot and waving a piece of paper upon which one of her staff had obviously listed the foreign buyers of US treasury securities, Sen. Stabenow roared before the television audience and wondered aloud what Mr. Greenspan was going to do about this problem!

"Sen. Stabenow was indignant that so many 'foreigners' owned US treasury securities, and she hoped that Mr. Greenspan would somehow come to his sense and

prohibit them from doing so in the future... or at least expose this as a problem that must needs be addressed immediately.

"Mr. Greenspan, visibly torn between laughing aloud at the Senator's idiocy and between disdain, but summoning up all of the will power necessary to answer her properly, said that he knew of no laws that these 'foreigners' had broken; that he knew of nothing he could do to stop them from making investments that they thought were well advised and reasonable; that without their purchases US interest rates might well have been a good deal higher than they are, and that there seems to be no movement on their part to create an untoward market circumstance by selling those securities presently. The only comment he missed making and one we wish he had made is that their purchases are a huge 'vote of confidence' in the US economy, not an indictment of same. Sen. Stabenow proved the wisdom of the old aphorism that it is far better to remain silent and thought of as an idiot than to say something and remove all doubts. In her case, there were few doubts before her appearance; now there are none."

As a prelude to a paper we are going to examine in detail in the next few weeks, there is reason to believe that long term interest rates might be at least 1% higher and perhaps as much as 2% without foreign buying of US government debt. 10 year treasuries at 6% would mean that 30-year mortgages would be well over 7%. That would create quite a slowdown in housing construction and at least put a lid on the rise in home values, if not reverse the trend. That would certainly slow the economy down.

While it is doubtful the Senator would wish for such an economic slowdown, this illustrates that there are consequences for individual investors to the "international trade game" that we will be discussing. It is not played in a vacuum.

Staying Vigilant Against Complacency

What I want to do over the next few weeks is to show you why Greenspan is right. You must remain vigilant against complacency. The last "Big Thing" to come upon the world was the bursting of the stock market bubble in 2000-2002. There was a new paradigm. The next Big Thing is likely to be the fallout from the rebalancing of global trade. You do NOT want to be on the wrong side of that trade. The good news is that we will muddle through. It is not the end of the world. However, the transition will not be fun. It will affect your bonds, your stocks, your home values and maybe your job. Assuming that tomorrow will be like today is a complacency that you cannot afford.

To start us off, I want to quote a few paragraphs about what Hyman Minsky wrote about financial balance.

"…Minsky characterized the financial balance along a scale of running from 'fragile' to robust.' 'Fragile finance' refers to states in which cash commitments are relatively heavy compared to cash flows, so that there is some danger of widespread failure to meet commitments, failure that might cause general breakdown in coherence. 'Robust finance' refers to states in which commitments are relatively light compared to

cash flows, so that the danger of incoherence is relatively remote. The emphasis on the threat of incoherence is one way of reading the scale.

"**Viewed more positively, what is so appealing about a state of 'robust finance' is that it leaves open many different possible future paths for subsequent social freedom. What is so tragic about a state of 'fragile finance' is that previous commitments leave open only very few possibilities for the future, and maybe no possibilities at all that are consistent with existing commitments.** Fragile finance is a state of social constraint. The degree of fragility or robustness in the economy as a whole ultimately depends on the fragility or robustness of financing arrangements at the level of the constituent economic units." (Perry Mehrling, The Vision of Hyman P. Minsky, 1998)

Or put more simply, if you have cash, you have more options. It would seem that the United States has fewer options, as we are the borrower, not the lender. But that is not entirely the case. While Europe does not feel the need to build up dollar reserves, thus lowering the values of their currency and financing our trade deficit, clearly Asia does. While they may have "cash." They also have "existing commitments," as Minsky put it, to support export growth as a way to increase employment and improve their national well-being.

What would happen, do you think, if China were to see their exports to the US decrease? What about all the spare capacity and who would use it? What about the bank loans made that are predicated on the kindness of US consumers being willing to forego savings and purchase Chinese goods? What about the expectations of the masses of poor who are looking for jobs, not to mention the loss of jobs from those currently employed? The Chinese must feel an existing commitment to be willing to take dollars that they surely must know will not be worth as much in the future.

Things Fall Apart; the Center Cannot Hold

"Things fall apart; the center cannot hold; mere anarchy is loosed upon the world, the blood-dimmed tide is loosed, and everywhere the ceremony of innocence is drowned." - William Butler Yeats

Yeats was not describing what has come to be called Bretton Woods 2, but it seems apropos to start with that quote. The first Bretton Woods system came about when representatives of most of the world's leading nations met at Bretton Woods, New Hampshire, in 1944 to create a new international monetary system. Because the US at the time accounted for over half of the world's manufacturing capacity and held most of the world's gold, the leaders decided to tie world currencies to the dollar, which, in turn, they agreed should be convertible into gold at $35 per ounce.

Under the Bretton Woods system, central banks of countries other than the US were given the task of maintaining fixed exchange rates between their currencies and the dollar. They did this by intervening in foreign exchange markets. If a country's currency

was too high relative to the dollar, its central bank would sell its currency in exchange for dollars, driving down the value of its currency. Conversely, if the value of a country's money was too low, the country would buy its own currency, thereby driving up the price.

The dollar became the world's reserve currency. Yet there were limits. Each country had to police its own reserves and currency or be forced to revalue. And the US was constrained because the dollar was fully convertible into gold. This changed in 1971 when Nixon closed the gold window.

Now we have what many are coming to call a Bretton Woods 2 system. That is where much of the world, but primarily the Asian countries, have more or less informally agreed to peg their currencies to the dollar. They do this in order to maintain their relative competitive ability to sell their products to the world and specifically to the US.

But this system is inherently more unstable than the first Bretton Woods. There is no gold conversion constraint upon the reserve currency. The US has few reasons to protect the value of the currency, and many reasons why they should want it to drop. And there is no formal agreement among the nations. Any nation at any time could begin to act unilaterally to change. Russia has specifically said they would start to have a larger euro component to their growing national reserves. Thailand has said the same, and indications are that they are putting actions behind their words.

For the rest of today's letter, and probably much of next week's, we are going to look at a rather remarkable paper called: "Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006" It is by Nouriel Roubini of the Stern School of Business at New York University and Brad Setser, Research Associate Global Economic Governance Programme at University College, Oxford University. It was done for a symposium held this month in San Francisco sponsored by the Federal Reserve Bank of San Francisco and University of California – Berkley. The symposium was called "Revived Bretton Woods System: A New Paradigm for Asian Development?"

Let's look at a few paragraphs from the introduction that helps us get our bearings to the problems that Roubini and Setser want to point out:

"The defining feature of the global economy right now is the $660 billion US current account deficit. The world's largest economy – and the world's preeminent military and geo-strategic power – is also the world's largest debtor. The current account surpluses of most other regions of the world are the mirror image of the US deficit. The US absorbs at least 80% of the savings that the rest of the world does not invest at home. Barring an economic slump in the US or a major fall in the dollar, the US current account deficit looks set to expand significantly in 2005 and 2006.

"The defining feature of the current international financial and monetary system is that it finances the United States' enormous external deficit – and the associated fiscal

deficit -- at low interest rates. The world's central banks, not private investors, provide the bulk of the financing the United States needs to sustain its deficits.

"…Michael Dooley, David Folkerts-Landau and Peter Garber, in a series of influential papers, have argued that the nations of the Pacific have constituted a new Bretton Woods system. In the original Bretton Woods system, Europe and Japan tied their currencies to the dollar; today the industrialized – and rapidly industrializing – Asian economies formally or informally tie their currencies to the dollar. Dooley, Folkerts-Landau and Garber, argue that this system of fixed and heavily managed exchange rates is fundamentally stable, and the intervention required to prevent Asian currencies from appreciating will continue to provide the bulk of the financing the US needs to run ongoing current account deficits.

"For countries on the periphery, the benefits of stable, weak exchange rates exceed the costs of reserve accumulation. China relies on rapid export-led growth to absorb surplus labor of hundreds of millions of low-skill poor workers from its vast agricultural sector into the modern, industrial and traded sector. Continued reserve accumulation by Asian – and other – central banks, in turn, allows the US to continue to rely on domestic demand to drive its growth, and to run the resulting large current account deficits. Indeed, the external deficits financed through a new renminbi-dollar standard are far larger than any deficits associated with the original gold-dollar standard or the original Bretton Woods system.

"Initially, Garber, Dooley and Folkerts-Landau suggested the new system of fixed and quasi-fixed exchange rates would last a generation, until China's agricultural labor surplus was absorbed in a new urban industrial sector. More recently, Peter Garber backed off a bit, but he still maintained that the new Bretton Woods system would last another eight years. Michael Mussa has suggested it will not last another four years. We believe it may have difficulty lasting for another two years.

"…we argue that there is a meaningful risk the Bretton Woods 2 system will unravel before the end of 2006."

Stability Breeds Instability

They find several sources of instability. Let's look at a few of them briefly. (I will try to find a web link for the paper by next week.)

First, as alluded to above, they see a tension between the growing need for financing by the US and the "large losses that those lending to the US in dollars are almost certain to incur as part of the adjustment needed to reduce the US trade deficit."

The world's central banks hold roughly $2.5 trillion of the $3.8 trillion worth of reserves in dollars. Asian central banks have roughly $1.8 trillion in dollars. If Asian currencies were to depreciate by 33%, that means Asian central banks would lose $600 billion, which is not a small sum. And it cannot be dismissed as merely a paper loss.

Most of the countries "sterilize" their dollar holdings in order to maintain the relative value of their currency and maintain control of their money supply and thus inflation. "To the extent that central banks have to sterilize their reserve accumulation, their dollar assets are offset by local currency liabilities that have to be paid. Central banks can always be recapitalized by taxpayers, but the new government bonds given to the central bank to make up for exchange rate losses have to be serviced out of the government's budget. That is a real cost."

Let's see if I can explain this. A business sells $ billion dollars worth of widgets to the US. When it comes back to the country, the business needs local currency to pay suppliers and employees, so they convert it to the local currency. This increases the money supply. At some point, that is inflationary, so the local central banks issues government debt to soak up the excess cash and try and maintain a stable money supply. That local debt has to eventually be paid. It is a real cost. If the dollar goes down, so does the value of its reserves, yet its debt in local currency has stayed the same. Someone (read taxpayer) has to make up the local currency losses.

For some smaller economies, these losses can be significant. As they point out in a footnote: "As Higgins and Klitgaard (2004) note, reserve holdings of some Asian economies are so large that the losses for some central banks from even small moves in their exchange rate as significant: a 10% appreciation of the Singapore dollar might reduce the local currency value of Singapore's reserves by 10% of GDP; a 10% move in the Taiwanese dollar would generate local currency losses of 8% of Taiwan's GDP." This is just one more reason why central banks would be reluctant to see the dollar drop.

Of course, that could change. What if Singapore started to move it reserves out of the dollar and into yen and euros? At some point, it makes sense to do so. But when? And if one country starts, do others follow? Is there some new Nash equilibrium out there?

Why Long Term Rates Are So Low

"Developing a clean test of the impact of central bank demand on interest rates is hard, and estimates of the impact vary substantially. Goldman Sachs (2004) has presented an analysis suggesting that central banks intervention is narrowing Treasury yields by only 40bps; Sack (2004) provides a similar estimate.[13] Truman (2005) notes that sustained intervention from central banks is similar to a sustained reduction in the fiscal deficit: his ballpark estimate suggests a $300 billion in central bank intervention might have a 75 bp impact. Research from Federal Reserve suggests a 50 to 100 bps impact (see Bernanke, Reinhart and Sack (2004)); PIMCO's Bill Gross puts it at closer to 100 bps, and Morgan Stanley's Stephen Roach puts it at between 100 and 150 bps."

Since 2000, Roubini and Setser tell us that all of the net new supply of Treasuries has been bought by non-residents, and that between 80-90% has been by central banks. One last quote and then I will wrap up for this week:

"Central bank demand made it easier for the US Treasury to shorten the maturity of the US debt stock, and thus to reduce relative supply of long term US Treasuries. By eliminating the 30 year bond and supplying very little of the 10 year bond, the US reduced the share of ten year and longer Treasuries in the overall marketable stock from 40% in 2001 to 31% at the end of fiscal 2004. The overall stock of marketable treasuries went up by $931 billion in FY 2002-04, but the stock of ten-year notes and longer-term bonds went up only by $35 billion. Had the share of longer term Treasuries in stock stayed constant, the increase would have been closer to $365 billion. Central banks clearly are not just buying short-dated bills and two and three year Treasury notes: US data indicates that they have been important participants in the five and ten year note auctions. Consequently, the stock of ten-year notes in private US hands has presumably gone down over the past few years despite the large increase in the overall Treasury stock. Treasuries of different maturities are a close substitutes, but the relative scarcity of the ten-year note and other longer dated Treasuries could nonetheless have had an impact on its yield.

"Consequently, the 40bp [basis point] Goldman estimate seriously understates the effects of the Asian intervention on the market. Considering the size of recent central bank purchases, the indirect impact of central bank intervention on private demand for Treasuries, the interaction between central bank reserve accumulation and Treasury debt management policy and the effects of Asian reserve accumulation on inflation and growth (general equilibrium effects), we would bet the overall impact would be closer to 200bps."

Part of the reason they think the affect is higher is that such large purchases by foreign central banks distorts the value of the dollar and inflation, as well as US GDP and trade. These all have an impact on interest rates, and are usually not taken into account by those who look at the impact of foreign currency buying upon US interest rates.

Yes, with a much lower dollar, the trade deficit would be lower. We would be investing in industry which would make things for trade, as we would be more competitive. Fewer jobs would go offshore.

But we would also be paying much higher prices for nearly everything. Inflation would be a problem, or the Fed would be fighting it with higher interest rates. That means a much slower economy, and the increase in value in your house? Forget about it.

There are no economic free lunches. There is a trade-off for everything. I prefer the market to make those decisions, but we do not have a free market in currencies. It is manipulated by Asian central banks, and that distortion is going to cause pain down the road.

The interesting exercise for us is to try and understand how all the "players" in the game will act. What kind of odd Nash equilibrium will they settle into? Will they all share some pain so as to lessen the total amount of pain, or will they seek to avoid as much personal pain as possible thereby causing more pain for everyone else? I am not

entirely optimistic, given the current level of the "vacuous rhetoric of globalization." But one can always hope. It will take more than a few beautiful minds to work this equilibrium equation out.

But that's enough for this week. There is a lot more to come the next few weeks on this topic.

And just for fun and a little surprise, next week I will tell you why the Bush administration and Congressional Republicans are making the problem worse. It is not a pretty picture.

Connecticut, Florida and Guacamole

Puerto Vallarta was just what the doctor ordered. What a beautiful place. Sun, margaritas and guacamole. Normally, I come back a few pounds heavier from eating massive quantities of guacamole and chips. This trip, we told them to bring us lettuce leaves instead of chips with the guac. Combined with a lot of fresh fish, I somehow came back the same weight, but got to eat a lot of guacamole.

I live in Texas, where there is no shortage of Mexican restaurants and guacamole. But there is simply no comparison. The Mexican version is far superior. Perhaps it is the avocado and fresher ingredients. Yet I can't get Mexican avocadoes, which cost a fraction of the California version. I wonder why the US government needs to protect me from Mexican avocadoes? Perhaps, as Gary North suggested, to help me enjoy paying twice the world price to protect Florida sugar growers.

I am in Connecticut and New York for the first part of next week, and then I go to Tampa and Orlando for a series of meetings and a private speaking engagement. Then I come back home where right now it looks like I will be home for the entire month of March. April is looking ugly, because I have to go to London for a course on English security law and then take a test 8 days later, so that means the first 13 days I will be in Europe. My partners there are already planning to move me through a few countries, but all in all it should be fun. Except for that test. I hate regulatory exams. I have taken over half a dozen, and always done quite well, but they do put stress into one's life. And if I fail this one, I have to go back the next month and try it again.

Enjoy your week. I will be having brunch with my new daughter-in-law and some of the kids for her birthday tomorrow morning. Being with family is always a good way to spend a weekend. Even if there is no guacamole.

Your wishing his mind was more beautiful analyst,

John Mauldin